DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

SUBJECT: U.S. DEBT POLICY -- THE ROLE OF COMPARABLE TREATMENT

Issue

U.S. policy on extending debt relief to foreign countries includes the notion that official credits and private credits should be rescheduled on "comparable" terms. Thus, U.S. policy seeks to avoid a situation where debt relief granted by the U.S. and other governments would serve to "bail out" private creditors (especially commercial banks). In recent months, some American bankers have expressed the view that U.S. policy on comparable treatment is being interpreted to require inappropriate actions on the part of the banks, and they have requested clarification of this policy.

Background

As far back as the 1968 debt-relief negotiations with Peru, the principle of comparable treatment for official and private creditors was incorporated in the multilateral debt-relief agreements negotiated by official creditors. The standard language contains a commitment by the debtor country to "seek to secure from other external creditors, including banks, rescheduling ... arrangements on terms comparable to those ..." obtained from official creditors.

U.S. policy on comparable treatment was not formalized until 1978 when the National Advisory Council adopted a statement of policy on debt reorganization (attached). The event precipitating the statement was Congressional action authorizing U.S. participation in the IMF's Supplementary Financing Facility. Specifically, Congressman Cavanaugh charged that the Executive Branch was prone to use debt relief to "bail out" commercial banks that had made imprudent loans to developing countries. The Administration responded that existing policies were designed to avoid actions of this nature, and transmitted to the Congress the text of the National Advisory Council Action. [1]

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[1] Ultimately an amendment was added to the IMF legislation requiring the Secretary of the Treasury to instruct the U.S. Executive Director in the IMF to seek to assure that no decision on use of IMF resources undermines U.S. policy making regarding comparability in debt rescheduling where official U.S. credits are involved.

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The earliest case when comparable treatment arose as a serious issue occurred in connection with a series of Paris Club negotiations with Zaire in 1976-79. Commercial bank exposure in Zaire was around $500 million, and yet the banks (led by Citibank) argued vehemently that they should not be required to extend debt relief to Zaire. By 1979, the official creditors took a firm position that they would not provide further debt relief to Zaire without "comparable" action by the banks. In late 1979, a debt-relief agreement with the banks was concluded, and a new Paris Club meeting was held shortly thereafter.

By contrast, a high degree of comparable treatment was achieved in the 1978 debt relief negotiations with Peru. The commercial banks set the pace by concluding a refinancing agreement covering 90 percent of the principal payments falling due in 1979 and 1980. These amounts were to be repaid in seven years including a three-year grace period. Subsequently, official creditors concluded a debt relief agreement with Peru on virtually the same terms.

More recently, the U.S. had some concerns about comparable treatment in the official debt relief negotiations with Turkey in 1980. Treasury prepared a limited quantitative analysis of the debt-relief arrangement proposed for official creditors to determine what amount of refinancing or new lending by commercial banks would be necessary to achieve comparability. Assuming the ratio of exposure before and after debt relief should be the same for both categories of creditor, the analysis concluded that an increase in bank exposure of around $350 million, over existing exposure of $6.5 billion, would be necessary. However, other equally valid approaches would have yielded different conclusions. The lesson drawn from this experience was that there is no single quantitative test of the comparability of private and official debt relief arrangments.

Discussion

1. Economic Arguments For and Against Comparable Treatment

There are two economic arguments underlying the principle of comparable treatment. First of all, when a country experiences a shortage of foreign exchange that prevents it from meeting all its obligations to external creditors, it should allocate the available foreign exchange among creditors in an equitable or nondiscriminatory fashion. To favor one category of creditor over another could lead aggrieved creditors to withhold further financial support, or to seize assets, which would undermine the country's efforts to re-establish its creditworthiness. (At present, the only creditors for which preferential access to scarce foreign exchange is sanctioned are the multilateral

development banks. This exception is implicit in multilateral debt-relief arrangements and has been considered to be in the mutual interest of both private and official creditors.)

The second argument is that, if official creditors eliminate risk from international lending by commercial lenders, then financial resources channeled through these lenders may be misallocated. Debt relief extended to a country by official creditors without comparable relief from private creditors would have the effect of reducing risk. It is this argument that is reflected in the Congressional concern with "bailing out" commercial banks.

There are two economic arguments against comparable treatment. They were both advanced by Citibank in seeking preferred status for commercial banks that had exposure in Zaire in the 1976-79 period. One argument is that banks are in the business of "serious" lending in contrast to governments that make loans for a variety of political, economic and humanitarian reasons. Thus, debt-service obligations to commercial banks (and other private lenders) should be met before obligations to governments when there is a foreign-exchange shortage. The other argument is a practical one. If banks are given preferred status, it is contended, they will continue to lend to a country experiencing payment difficulties (or a particular borrower that plays a key role in the economy) -- and this will enable the country to resume paying its official creditors on schedule sooner. There are obvious rebuttals to both arguments.

It is also worth pointing out that banks in a number of cases have provided debt-relief even though official creditors have not provided such relief -- most recently to Bolivia and Jamaica. In other words, our policy on comparable treatment is not symmetrical -- and deliberately so.

2. Defining Comparable Treatment

Even if the principle of comparable treatment is accepted, questions remain regarding what constitutes comparable treatment and whether the U.S. government should establish standards for comparable treatment.

In composing the 1978 statement of U.S. policy, various formulations were considered. In the end, there was interagency agreement that the vague phrase "comparable treatment" was the best. However, the following explanation was included in a background section accompanying the policy statement that was transmitted to the Congress:

> Comparability can be achieved without actually rescheduling or refinancing debt-service payments, if the private creditors agree to extend additional credits (i.e., greater than the amount which would have been rescheduled or refinanced if they had chosen those

rescheduled or refinanced if they had chosen those methods of debt reorganization) to the debtor country on terms comparable to those negotiated in the [official] creditor club.

The point of the explanatory language is that debt relief can take many forms, and that the U.S. policy on comparability does not require private creditors to extend relief in any particular form. In practice, there are four main elements to comparability: the consolidation period, repayment period, amounts, and the treatment of interest. (A basic feature of debt relief arrangements is that there are trade-offs among the different elements.)

Sometimes commercial banks provide debt relief by restructuring the entire stock of their outstanding debt, or a portion of it. Official creditors have never done this because their debt is predominantly long-term debt with final maturities as far as 50 years in the future. Therefore they reschedule payments on their debt falling due during a relatively short period, usually one year, referred to as the consolidation period. When commercial banks also use a consolidation period approach, then a congruence of consolidation periods would be necessary to achieve comparability ceteris paribus.

The repayment period for rescheduled debt usually includes a grace period. In recent operations, the longest grace period offered by official creditors has been five years, and the largest repayment period (including grace years) has been 11 1/2 years. To be comparable, grace and repayment periods in official and private debt-relief arrangements need to be quite close, ceteris paribus.

The amounts of relief are determined by the consolidation period, and the percentage of payments subject to consolidation. (Typically 80-90 percent of the payments fallng due are rescheduled, with the 10-20 percent remaining to be paid according to the original schedules.) Amounts must be considered separately because exposure levels can be very different prior to debt relief and because new lending can substitute for rescheduling or refinancing. For example, if commercial bank exposure is twice as large as government exposure, then the banks would need to provide roughly twice as much relief ceteris paribus to ensure comparability. In another case, governments might provide substantial amounts of new credits in addition to debt relief. If private creditors are reducing their exposure in the country at the same time, governments could be criticised for "bailing out" the private creditors.

The treatment of interest in debt relief arrangements is by far the thorniest aspect of comparability. On the official side, there has been a willingness to reschedule interest as well as principal payments in most cases. In addition, the practice of official creditors is to charge concessional interest rates on debt relief provided for concessional loans and market-related rates on relief provided for export credits and other non-concessional loans.

On the private side, however, there has been great reluctance to capitalize interest payments, or provide relief with respect to these payments in any other form. This reluctance obviously stems from the desire to avoid, in effect, transforming interest due into ever-mounting non-performing assets that would be critically appraised by internal or external auditors. Such a situation might require that earnings be placed on a cash rather than an accrual basis and/or that additional loan loss reserves be lodged -- both of which would reduce the banks' reported income. Beyond this, there also seems to be a sense among bankers and bank regulators alike that providing debt relief on interest payments is fundamentally wrong.

Acknowledging the validity of the bankers' views, government creditors have not insisted that interest be rescheduled in order to achieve comparability. In fact, there is only one case (Nicaragua in 1980) where relief on interest payments was an integral part of a debt-relief agreement involving commercial banks. However, there are two current cases where relief on interest owed to commercial banks is a clear possibility: Poland and Sudan.

The issue is particularly significant when interest rates are high. On the one hand, the interest portion of debt service due is much higher and excluding interest due to private creditors could significantly decrease the scope for debt relief. Moreover, in the inflationary periods that produce high nominal interest rates, interest payments entail in real terms a significant amount of principal repayment (although bankers are probably unimpressed by this thesis). On the other hand, banks have to fund any new asset, including capitalization of interest, at rates that are nearly as high as lending rates, and thus stand to lose a good deal more if they are unable to take accrued interest into income.

The commercial banks have sensed some pressure from governments (and from the IMF and the IBRD) to be "more generous" in their debt relief arrangements. In response, some bankers have sought a clearer definition of comparable treatment. They would like a more explicit understanding that banks are not expected to duplicate Paris Club terms, and particularly not to reschedule interest due.

From the U.S. Government's point of view, the major difficulty with providing a clearer definition of comparability is that there is no satisfactory methodological or conceptual basis for doing so. Since every debt-relief case is different, there is much to be said for a case-by-case approach based on the kind of general principles included in the 1978 policy statement. It is easy, for example, to conjure up a case where political/strategic interests on the part of governments argue for very generous debt relief terms (a la Indonesia in 1970) that would be entirely inappropriate for banks. It is

equally easy to imagine a case where the country is so broke that banks have no alternative to charging off the loans other than rescheduling interest payments (a la Nicaragua). Whatever the circumstances, however, U.S. Government policy is to avoid intervening in banks' commercial judgments (as distinct from pointing out the potential consequences of various courses of action and from routine exchanges of view on the economic and political prospects of particular countries). In short, there is a certain contradiction between non-intervention in the lending decisions of banks and taking any action aimed at achieving comparable treatment.

3. Appropriate Terms in Prolonged Cases

The procedures that the international financial community follows for assisting countries experiencing critical debt-servicing difficulties have evolved over the last 25 years. These procedures have worked satisfactorily except in several cases of "prolonged debt crisis". In chronological order, these are the cases of Zaire (1976), Turkey (1978), and Sudan (1979). There is some evidence that the debt relief provided in each case by official and private creditors has helped to prolong the crisis. On the official side, repayment terms were set in early negotiations that had to be revised in subsequent negotiations (through rescheduling of "previously rescheduled debt"). On the private side, the very high interest rates recently prevailing in international capital markets that are applied to the relief offered by banks have represented a heavy claim on the countries' scarce foreign exchange resources, making it more difficult for the countries to restore the productive capacity of their economies.

In the next 3-4 months, the U.S. Government faces difficult negotiations with both Sudan and Zaire. In the context of each of these cases, it will be necessary to examine innovative approaches to official debt relief that will be more effective in helping these countries re-establish their creditworthiness. Innovation on the official side, if not matched by innovation on the private side, however, may raise comparable treatment as a public issue.

Conclusions

1. Comparable treatment between private and official creditors should continue to be an important element of U.S. policy on the extension of debt relief to foreign countries.

2. The vagueness of the term "comparable treatment" reflects the fact that USG policy aims toward "comparable" but not necessarily "identical" treatment for official and private creditors. In any particular case, the objectives and constraints for official and private creditors may properly differ. Thus the term "comparable treatment" allows for needed flexibility in the application of U.S. policy.

3. Comparable treatment does not necessarily require that commercial banks provide relief on interest payments when governments do so, although under some circumstances new credits might be the only alternative. The policy of the U.S. Government not to become involved in the commercial judgments of commercial banks extends to decisions on debt relief.

4. Innovative approaches by official creditors for dealing with "prolonged debt crises" may be necessary. Comparable treatment may pose difficulties for innovations in these cases, but it should remain as an objective.

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